

3rd Annual Research Symposium of the
Baghdad-Erbil-Erlangen Project (BEEP)

**European Monetary Policy in
Turbulent Times**

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Winter Course for Iraqi Social Scientists

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Monetary Developments in Germany and in the European Union

Prof. Jürgen Kähler PhD

Seven years ago: Conclusions

- The ECB structure is well-designed.
- The ECB has been very successful.
- The € is a stable currency that will increase its importance in finance and trade.
- The Euro area will increase.
- Convergence will not be easy for the acceding countries.

What has happened since then?

- International banking and financial crisis from 2008 to 2010
- European debt crisis since 2010
- Resignation of the president of the Bundesbank, Axel Weber, February 2011
- Resignation of Jürgen Stark, member of ECB's Executive Board, September 2011

Convergence criteria I

- Price stability: Inflation not more than 1.5 percentage points higher than in the 3 best performing member states
- Long term interest not more than 2 percentage points higher than in the 3 member states with the lowest inflation rate
- Sustainability of government financial position
- Ratio of government deficit to GDP smaller than 3 per cent
- Ratio of government debt to GDP smaller than 60 per cent
- Exchange rate stability: 2 years of membership in the exchange-rate mechanism (fluctuation margins $\pm 15\%$)

Values of Convergence Criteria (1997)

	Inflation	Interest Rate	Budget Balance	Public Debt
Austria	1.1	5.6	-2.5	66.1
Belgium	1.4	5.7	-2.1	122.2
Finland	1.3	5.9	-0.9	55.8
France	1.2	5.5	-3.0	58.0
Germany	1.4	5.6	-2.7	61.3
Ireland	1.2	6.2	0.9	66.3
Italy	1.8	6.7	-2.7	121.6
Luxemburg	1.4	5.6	1.7	6.7
Netherlands	1.8	5.5	-1.4	72.1
Portugal	1.8	6.2	-2.5	62.0
Spain	1.8	6.3	-2.6	68.8
Greece (1999)	2.1	6.3	-1.6	104.4
Reference value	2.7	7.8	-3.0	60.0

Convergence criteria II

- Government Debt:

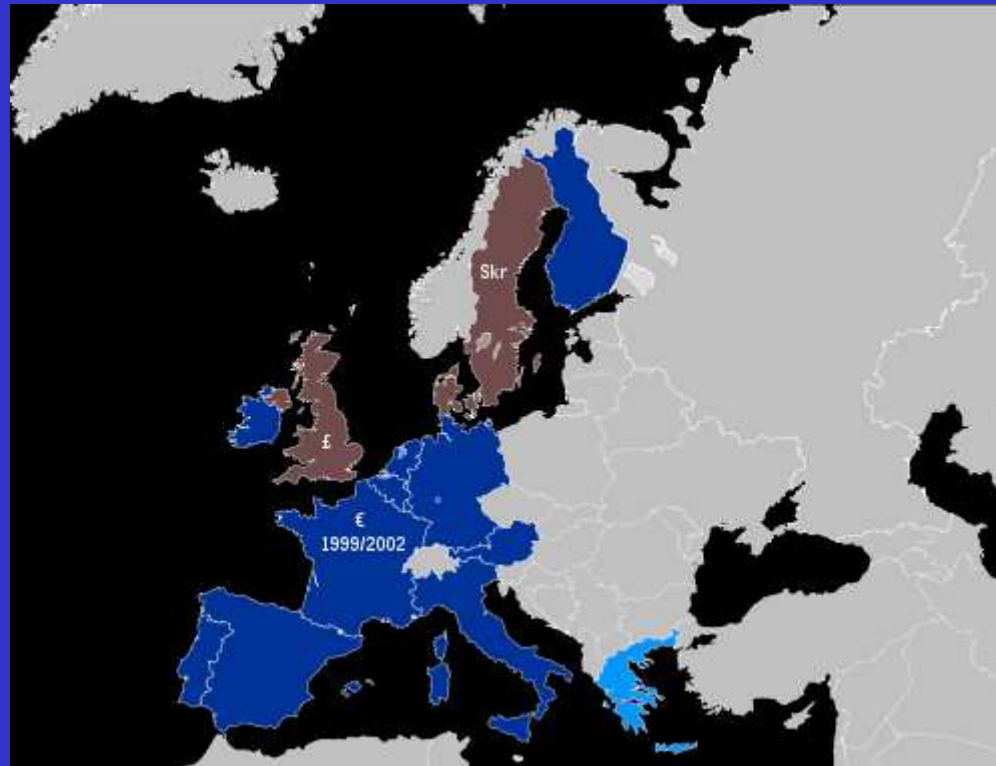
the ratio of government debt to GDP must not exceed 60% -

unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.

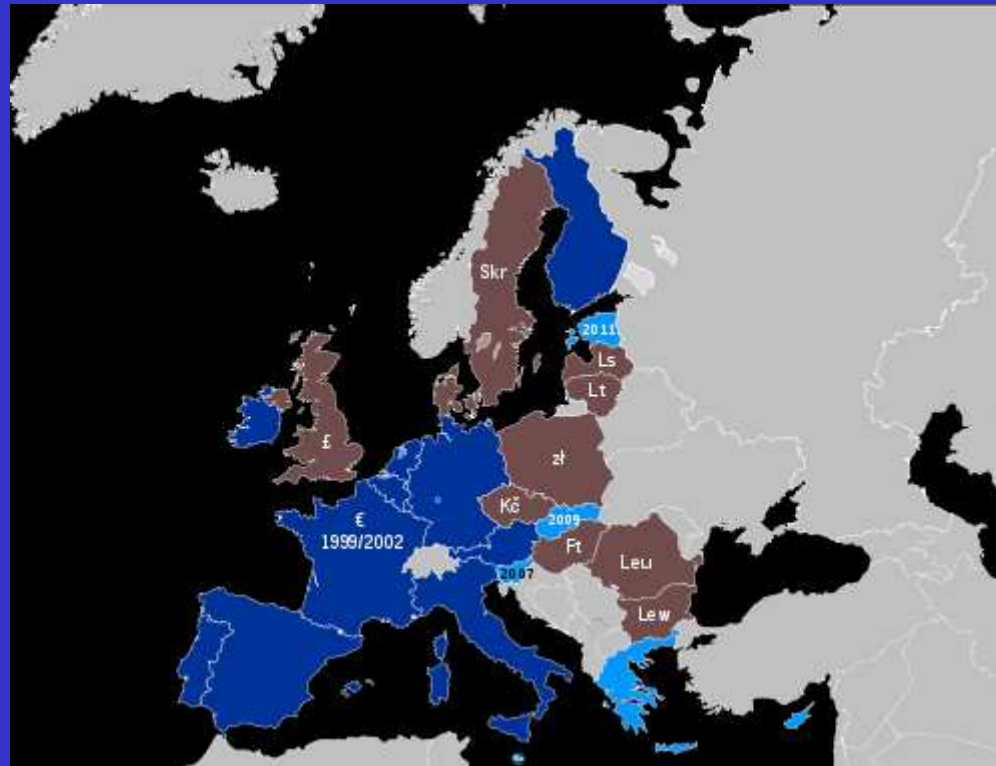
Manipulation of statistical data by Greece: Budget Deficit/GDP

Year	Reported	True
1997	4.0	6.6
1998	2.5	4.3
1999	1.8	3.4

Eurozone 2002



Eurozone 2011



Status of the ECB

Treaty establishing the European Community (1991)

- Primary objective: Price stability
- Independence
- No financing of public deficits
- No-Bail-Out Clause

Price stability

Article 127 (1)

The primary objective of the ESCB shall be to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Community with a view to contributing to the objectives of the Union as laid down in Article 3.

Independence

Article 130

When exercising the powers and carrying out the tasks and duties conferred upon them by this Treaty and the Statute of the ESCB, neither the ECB, nor a national central bank, nor any member of their decision-making bodies shall seek or take instructions from Union institutions or bodies, from any government of a Member State or from any other body.

No financing of public deficits

Article 123 (1)

Overdraft facilities or any other type of credit facility with the ECB or with the central banks of the Member States in favour of Union institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States shall be prohibited, as shall the **purchase directly from them** by the ECB or national central banks **of debt instruments**.

No-Bail-Out Clause

Article 125 (1)

The Union shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any Member State. **A Member State shall not be liable for** or assume **the commitments** of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings **of another Member State.**

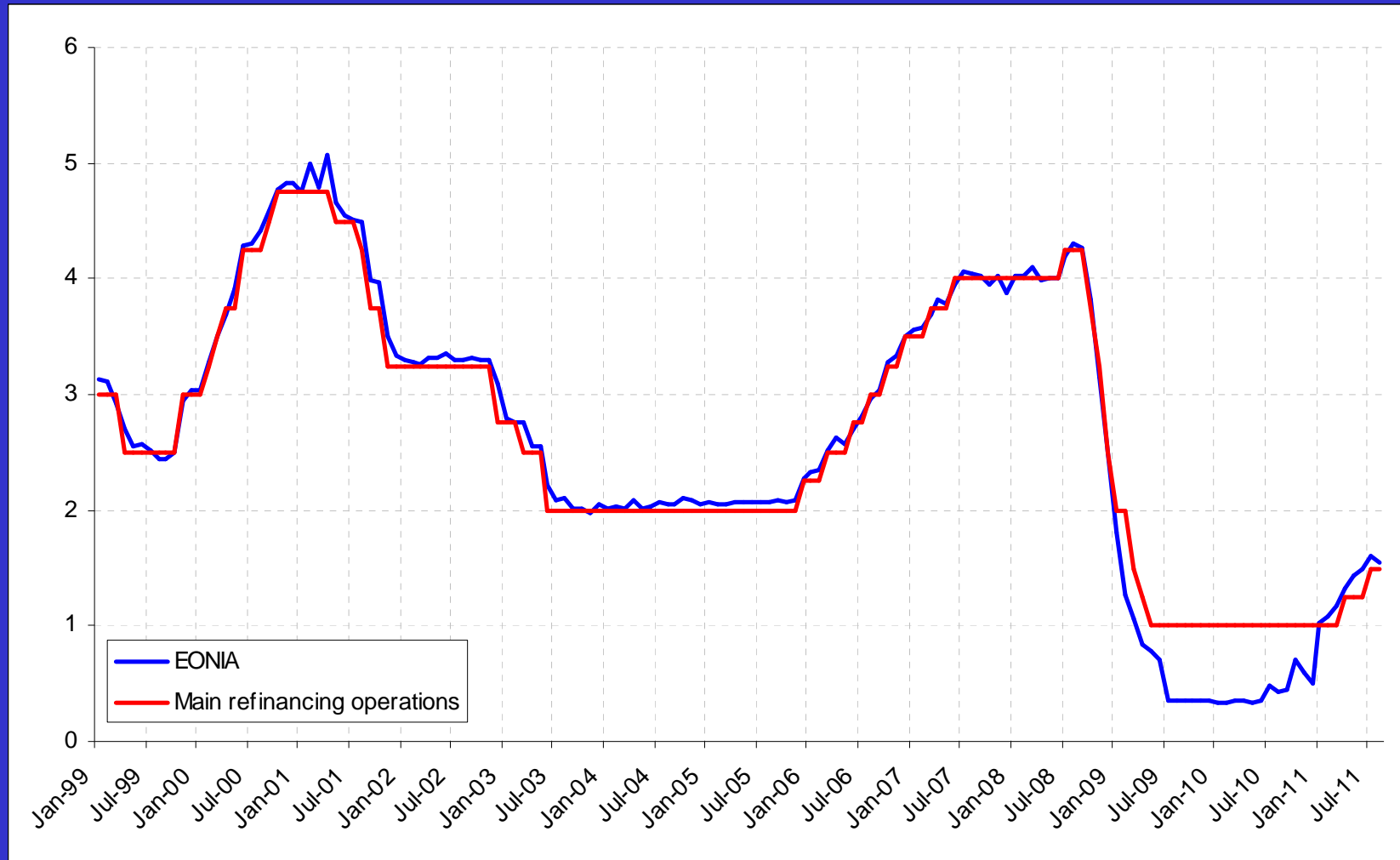
Structure of the ECB

- Decision-making bodies
- Executive Board: 6 members (currently from France, Portugal, Spain, Italy, Germany and Belgium)
- Governing Council: Members of the Executive Board and governors of NCB from countries that have adopted the Euro

Reaction of the ECB to the Subprime Crisis

- Quick and drastic decrease of the key interest rate
- Full allotment
- Qualitative easing: lower rating of collateral accepted
- Longer maturity of operations
- Purchase of covered bonds
- ‘Money-market maker of last resort’

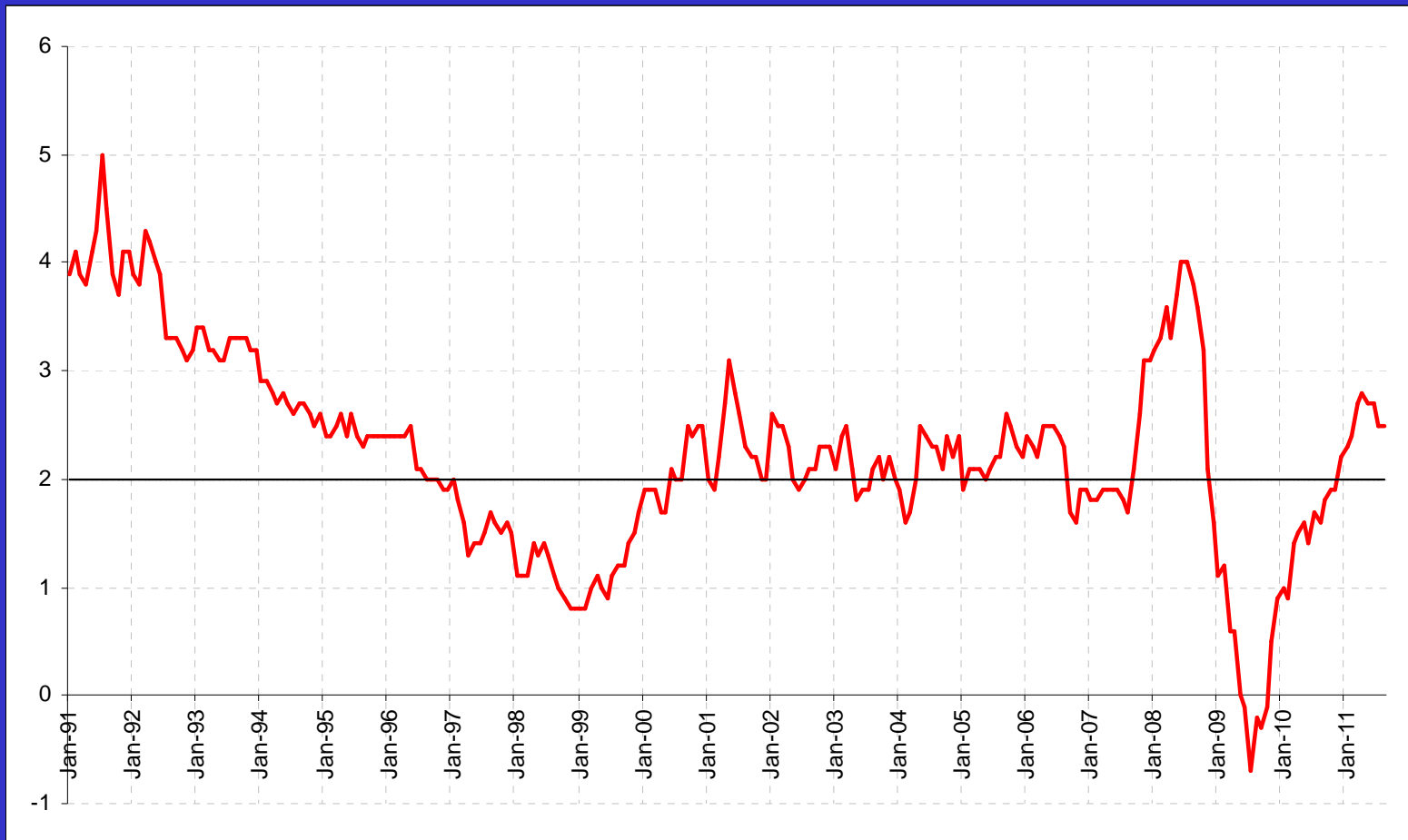
The ECB's Key Interest Rate



The ECB's Monetary Base (million €)

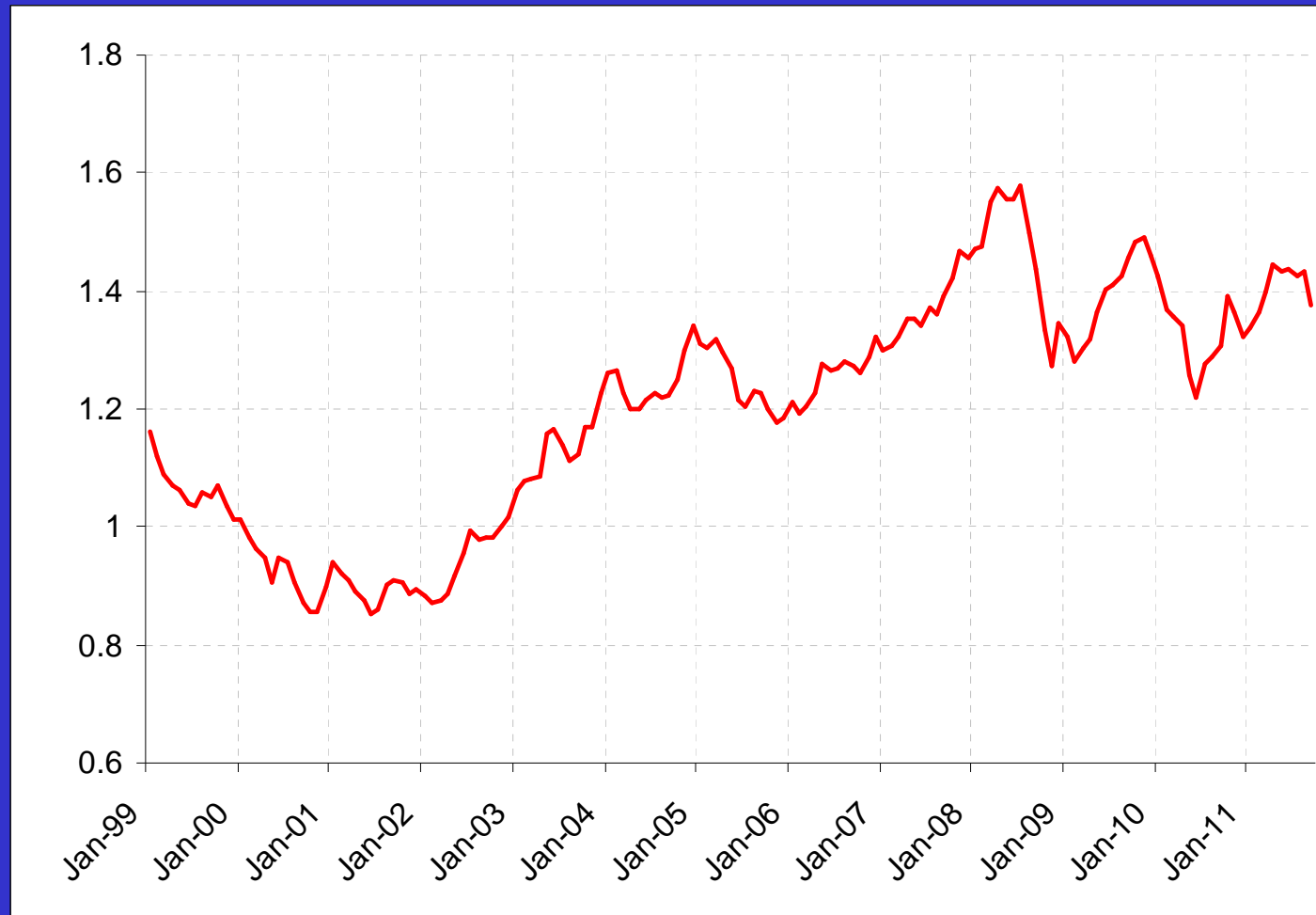


Inflation in the Euro Area



Dollar-Euro Exchange Rate

(Jan. 1999: 1.17 \$/€)



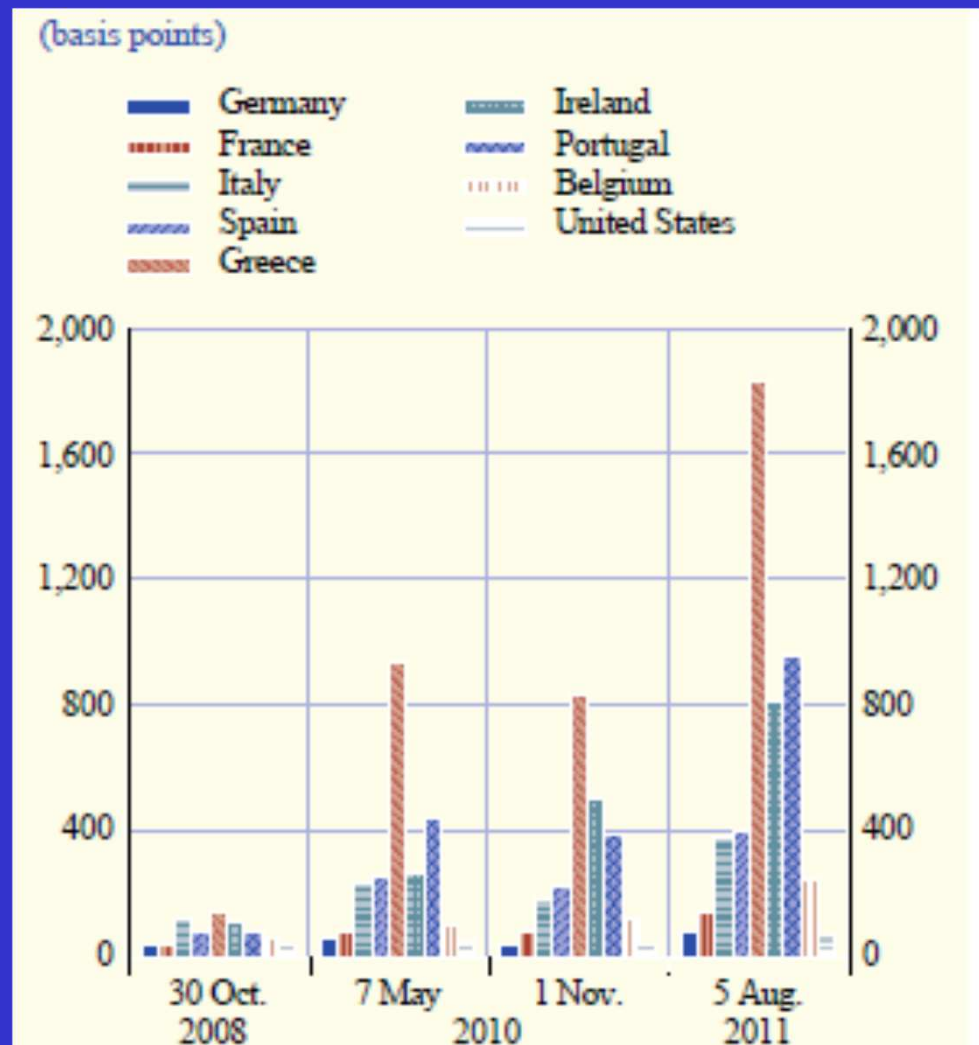
Verdict on ECB's Monetary Policy During the Subprime Crisis

- Stabilization of the financial system is not an official objective of the ECB.

Nevertheless:

- Quick and decisive action by the ECB
- Banking system was stabilized
- No increase in inflation
- No devaluation of the Euro
- No loss of reputation of the ECB

The Debt Crisis Since 2010: 5-Year CDS Premia



Measures of the ECB

- May 2010: Purchase of PIGS bonds (€ 40 billion)
- May 2010: ECB accepts Greek bonds as collateral, irrespective of rating
- December 2010, the ECB increases its subscribed capital from €5.76 to €10.76 billion
- March 2011: ECB's stock of PIGS bonds: € 77 billion)
- August 2011: Purchase of PIIGS bonds: € 22 billion

Questions Raised by Debt Crisis

- Should the ECB buy government debt?
- Should the ECB target only inflation or also financial stability?
- Would a default by Greece create a systemic financial crisis?
- Should Greece leave the Eurozone?